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SUBJECT: HOUSING MARKET FINALLY COOLING, BUT THE
CONVENTIONAL WISDOM STILL SUGGESTS A SOFT LANDING FOR SPAIN

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¶1. SUMMARY: As the Spanish economy pushes forward toward matching wealthier EU members, it continues to face challenges. Spain must increase its competitiveness across the board, especially in its labor markets, energy utilities and telecoms. What has been of most immediate concern lately, however, has been the housing and construction situation. The housing market is cooling off. Mortgage rates have risen from 3.4% in June of 2006 to 4.49% in June 2007. Home sales have fallen by 11.5% over the last year, with a 15.9% fall in the sale of new homes. New home prices rose by 7.4% during Q1 2007 compared to 12.7% over the same period the year before. During the May-July 2007 timeframe, apartment prices in Madrid and Barcelona actually went down by about 5% according to the Ministry of Housing. This is of concern because the Spanish economy is significantly dependent on construction, which contributes up to 18% of GDP (roughly twice the Euro zone average); and accounts for a quarter of all economic growth. Despite increasing risks however, there are enough offsetting factors suggesting a soft landing for Spain's economy. END SUMMARY.

RISING INTEREST RATES
SPARK FEARS FOR HOUSING
MARKET

¶2. Cheap credit through low interest rates has been a driving factor in the construction/housing led boom following the introduction of the Euro. Interest rate hikes therefore are at the heart of fears of a sharp economic slowdown. The potential chain reaction begins with the fact that higher interest rates could lead to more foreclosures, making lenders more cautious. Lenders are already moving to sell off delinquent accounts as well as some of their current mortgages. Spanish households, even Qthey can mostly make the higher payments on their variable interest rate loans, have to reduce consumption, thereby at some point lowering demand, although this is being offset somewhat by more investment. The effect on Spanish households' consumption patterns is probably more macroeconomically significant than the risk of foreclosures as getting a mortgage loan is much harder in Spain than in the U.S. so, overall, most borrowers in Spain are a fair credit risk.

VARIABLE RATE MORTGAGES
BECOMING A PROBLEM

¶3. Currently many Spaniards are spending over 40% of their gross income on their mortgage. In order to be able to afford the soaring prices of the recent housing boom, Spaniards have been forced to take on very large, variable rate mortgages with exceptionally long terms of up to forty and fifty years. The average monthly mortgage in April 2007

was 7% higher than the year before and had an average term of 26 years. Furthermore, of all the mortgages granted in April 2007, 97.7% were of the variable rate variety with almost 90% of those being fixed to the Euribor. This continues the trend of Spanish families becoming more overextended financially and exposed to interest rate rises.

OTHER POTENTIAL NEGATIVE
ECONOMIC FACTORS

¶4. Many Spanish households will likely cut back on consumption to keep current on their mortgage payments, further slowing the economy. Joint decreases in construction and consumption should increase unemployment. Spain has seen its advantages in competitiveness among major EU nations erode as productivity is low and inflation is higher than average in the eurozone. Spain suffers from a low productivity growth rate of .8%, behind even Portugal among top EU nations, and is furthermore losing its wage advantage to Eastern Europe and Asia. European Union (EU) subsidies will also be phased out; although, the effect will not be felt in the immediate future as Spain will not become a net contributor until 2013. The significance of construction and housing to the Spanish economy suggests a cumulative effect from the drop in housing demand causing a significant downturn.

BUT, THE SOFT LANDING
SCENARIO HAS SUBSTANCE

¶5. Despite the hovering dark clouds, there is another side to Spain's overall housing picture. First, the demand declines in the overbuilt suburbs and coasts mask continued strong demand for housing and office space in major cities. Sources of continued demand are expected to be continued immigration, split couples as divorce has become more common, and the strong demand for housing among young people (Ref 06 Madrid

01750). Also, there is the potential that slackening northern European demand for vacation homes might pick up or perhaps emerging EU nations such as Poland will take up the slack. Finally, ECB interest rate rises may in fact turn out to be a stabilizer by reigning in spending by overextended Spanish consumers and businesses and encouraging more savings and the paying down of debt.

MAJOR REAL ESTATE GROUPS
DIVERSIFYING

¶6. On the construction/real estate company side, although speculators and the extraordinarily large number of small time firms are likely to get hit, all the largest players have taken the opportunity of the boom years to diversify by buying into Spanish energy utilities, water treatment plants, airport management firms, and toll roads; as well as investing overseas to tap emerging markets. Spanish construction firms also seek to take advantage of new building and infrastructure projects in Eastern Europe. There the Spaniards expect to leverage their experience with contracting and managing projects built under EU funds. Furthermore, the Spanish government itself is expected to increase its already high spending on infrastructure. Spain's budget surplus gives the government some room for maneuver to use fiscal policy as a stabilizer.

R&D INVESTMENT AND
CAPITAL GOODS SPENDING
TRENDING UPWARDS

¶7. R D in Spain is currently low, but R D spending is a government priority, mostly to help improve Spain's low productivity rates. While government spending on R D is budgeted at 6.5 billion Euros in 2007, a 35% yearly increase, Spain's total R D spending is still only 1.03% of GDP, half the EU average. However, the government has fairly credible

plans to raise this number to 2% by 2010, and increase the private sector's share from 46% to 55% of total R D. Spain plans to increase private R D spending through better incentives for private sector innovation and patent registration, as well as through improved links between business and government sponsored research bodies. (Note: It is pretty clear that R&D spending will go up, although it is not clear whether providing the extra money will actually have the impact on productivity the government wants.) Moreover, capital goods investment increases are expected to continue as Spanish industrial firms increase their production capacity to meet demand emanating from a resurgent German economy. Capital goods spending is already up 7.2% this year and is expected to continue well into double digits this year and remain strong thereafter. Capital goods spending is expected to be an economic driver for Spain and in combination with increased R D could help improve productivity, although no observers believe Spain is on the verge of becoming an innovation driven economy.

SOFT LANDING STILL
SEEMS LIKELY

¶8. The safe bet on the direction of the Spanish economy is still the soft landing. This is because it appears that major banks and corporations have protected the better part of their boom profits, and new opportunities for growth in the construction sector are expected. Demographic and social trends also suggest continued robust housing demand. Given that the percentage of all homes and apartments that are rentals in Spain was 11.4% last year compared to an EU average of 38%, high prices, strong demand, and perhaps (in the future) more balanced landlord/tenant laws might lead to more of a rental market. Currently, average Spanish mortgage holders, small time developers, and speculators appear to be most vulnerable to weaknesses in the housing market. Overall though, Spain looks set to weather the storm despite the troubles in the housing market. This Embassy analysis tracks largely with the conclusions of the IMF's latest Article IV consultations with Spain, although both the Fund and the Embassy are cognizant that while the soft landing scenario is likely, it is by no means guaranteed. A May 2007 Morgan Stanley analysis is consistent with this view as well, although it does not discount the possibility of a recession in 2009. The conservative PP opposition party linked economic/business consultancy, Montoro y Asociados Asesores concludes: "in Spain the slight slackening in economic growth which might happen in the coming months does not put into risk the maintenance of rates of growth of over 3% with considerable employment generation". Most analysts are optimistic for the short-term, despite Madrid stock exchange volatility and reports of greater difficulties for big corporate borrowers. The bottom line: it appears that the government will meet the electorate (parliamentary elections

must be held by March 2008 at the latest) with the economy still growing strongly.
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